2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Administrator, Federal Aviation Administration
Inspector General, U.S. Department of Transportation:

We have audited the accompanying consolidated balance sheet of the Federal Aviation Administration (FAA) as of September 30, 2002, the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources for the year ended September 30, 2002 (herein referred to as financial statements). The objective of our audit was to express an opinion on the fair presentation of these financial statements.

In connection with our audit, we also considered the FAA's internal control over financial reporting and tested the FAA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the financial statements, we concluded that the FAA's financial statements as of and for the year ended September 30, 2002, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America. The accompanying consolidated balance sheet and consolidated statement of net cost of the FAA as of and for the year ended September 30, 2001, were audited by other auditors whose report expressed an unqualified opinion before the adjustments, audited by us and discussed in Note 15 to the financial statements. As discussed in note 5 to the financial statements, the FAA implemented a change in accounting principle related to the classification and accounting for field spares. Also, as discussed in Note 16, the FAA restated its beginning of the year obligated and unobligated balances in the combined statement of budgetary resources.

Our consideration of internal control over financial reporting resulted in the identification of reportable conditions in the following areas:

1. Process for estimating liabilities for legal matters
2. Controls and processes over financial reporting and account reconciliations
3. Process for estimating environmental liabilities
4. Accounting methods and controls over completeness of field spares
5. Controls over property, plant, and equipment
6. Information technology controls over third-party systems and applications
7. Information technology controls over FAA systems

We consider the first reportable condition, regarding the process for estimating liabilities for legal matters, to be a material weakness.

The results of our tests of compliance with certain provisions of laws and regulations, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA),disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and

Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The results of our tests of compliance with the FFMIA disclosed instances where the FAA's financial management systems did not substantially comply with Federal financial management system requirements and the use of the United States Standard General Ledger at the transaction level.

The material weakness, reportable conditions, and the FFMIA compliance issue, along with our recommendations, have been discussed with, and agreed to, by key FAA management officials. FAA management has indicated that corrective actions have been or will be implemented during fiscal year 2003.

The following sections discuss our opinion on the FAA's fiscal year 2002 financial statements, our consideration of the FAA's internal control over financial reporting, our tests of the FAA's compliance with certain provisions of applicable laws and regulations, and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheet of the FAA as of September 30, 2002, the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources for the year then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FAA as of September 30, 2002, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year then ended, in conformity with accounting principles generally accepted in the United States of America. The consolidated balance sheet and statement of net cost of the FAA as of and for the year ended September 30, 2001, were audited by other auditors whose report dated February 27, 2002, expressed an unqualified opinion on those statements before the adjustments discussed in Note 15 to the financial statements. We audited the adjustments described in Note 15 that were applied to the fiscal year 2001 consolidated balance sheet and statement of net cost, and in our opinion, such adjustments are appropriate and have been properly applied.

As discussed in note 5 to the financial statements, the FAA implemented a change in accounting principle related to the classification and accounting for field spares. Also, as discussed in Note 16, the FAA restated its beginning of the year obligated and unobligated balances in the combined statement of budgetary resources.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the fiscal year 2002 financial statements taken as a whole. The Other Accompanying Information is presented for purposes of additional analysis and is not a required part of the fiscal year 2002 financial statements. Such information has been subjected to the auditing procedures applied in the audit of the fiscal year 2002 financial statements and, in our opinion, is fairly stated in all material respects in relation to the fiscal year 2002 financial statements taken as a whole.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2002 audit, we noted certain matters, described in Exhibits 1 and 2, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that the reportable condition presented in Exhibit 1 is a material weakness. Exhibit 2 presents the other reportable conditions. A summary of the status of the prior year reportable condition is included as Exhibit 3.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of the FAA.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with certain provisions of laws and regulations described in the Responsibilities section of this report, exclusive of FFMIA, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 01-02. In accordance with the *Federal Managers' Financial Integrity Act of 1982* (FMFIA), the Secretary of Transportation reported to the President that Department of Transportation (DOT) was not in full compliance with FFMIA, as DOT's core accounting system, which FAA uses, does not meet Federal systems requirements. In addition, the Secretary reported that FAA's property systems also did not conform with Federal systems requirements and that there were weaknesses in the area of information systems security within DOT and the FAA's process for closing out cost-reimbursable contracts.

The results of our tests of compliance with FFMIA disclosed instances where the FAA was not in substantial compliance with Federal financial management system requirements and the use of the United States Standard General Ledger at the transaction level. Details of the compliance matters are included in Exhibit 4.

RESPONSIBILITIES

Management's Responsibilities

The *Government Management Reform Act of 1994* (GMRA) requires each federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the DOT in meeting the GMRA reporting requirements, FAA prepares annual financial statements.

Management is responsible for:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal control over financial reporting, and preparation of the Management's Discussion and Analysis (including the performance measures), the Required Supplementary Information, and the Required Supplementary Stewardship Information; and
- Complying with laws and regulations, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the FAA's fiscal year 2002 financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audit provides a reasonable basis for our opinion.

In planning and performing our fiscal year 2002 audit, we considered the FAA's internal control over financial reporting by obtaining an understanding of the FAA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the

FMFIA. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the FAA's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of the FAA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No.01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the FAA's fiscal year 2002 financial statements are free of material misstatement, we performed tests of the FAA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to the FAA. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the FAA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

DISTRIBUTION

This report is intended for the information and use of the FAA's management, the Department of Transportation's Office of the Inspector General, OMB, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

January 24, 2003

Material Weakness

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

This section contains our discussion of the reportable condition that we believe is a material weakness.

1. Process for estimating liabilities for legal matters

Condition

The FAA did not have adequate controls to ensure that the basis for the estimated liability for legal matters pending against the FAA, both those recorded as liabilities and disclosed in the notes to the financial statements, were accurate. The Office of General Counsel's (AGC) initial estimate was overstated by approximately $514 million as cases deemed to be *reasonably possible* of loss were incorrectly included with those deemed to be *probable* of loss. Additionally, the AGC incorrectly reported those cases where the likelihood of loss was deemed to be *remote.* As a result, the notes to the fiscal year 2001 financial statements incorrectly stated that the FAA had legal contingencies totaling $20 billion. These errors occurred because the AGC did not have an adequate comprehensive understanding of financial reporting requirements, and the Office of Financial Management (AFM) had not established a process to review information developed by the AGC.

In addition, the AGC is not providing the AFM with the necessary information to make quarterly adjustments to the estimated accrued liability related to legal matters. The FAA, as with other Federal government organizations, must rely on its legal counsel to provide information to record estimated and actual legal liabilities in the financial statements. In the past, the AGC has generally only provided this information in response to the annual independent auditors request, which will not be sufficient to comply with the new OMB interim reporting requirements for fiscal years 2003 and beyond. As of 75 days after year-end (December 15, 2002) the FAA was still making inquiry and receiving relevant information needed to produce materially correct financial statements.

We noted the following matters related to legal liabilities and communications with the AGC:

- *Communications with the AGC* – the FAA has not established a plan of communication that would ensure timely periodic (at least quarterly) material updates be provided to the AFM;

- *Quality and consistency of information received from the AGC* – The information provided by the AGC is fragmented, inconsistent, often incomplete, and in some cases erroneous – requiring substantial follow-up to resolve questions and determine proper case status and dollar estimates.

Criteria

Statement of Federal Financial Accounting Standard (SFFAS) No. 5, *Accounting for Liabilities in the Federal Government* has defined pending or threatened litigation and possible claims and assessments as a loss contingencies. The Standard states that contingent future outflows of resources as a result of past transactions or events may be recognized, may be disclosed, or may not be reported at all, depending on the circumstances. Legal contingencies should be recognized as a liability when the likelihood of loss is *probable* and *reasonably estimable* or measurable. A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is a reasonable possibility that a loss may have been incurred. Disclosures should include the nature of the contingency and an estimate of the possible liability, and estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

The Office of Management and Budget (OMB), Circular A-123, *Management Accountability and Control*, states "management controls are the organization, policies and procedures used by agencies to reasonably ensure that… reliable and timely information is obtained, maintained, reported and used for decision making. In addition, the Joint Financial Management Improvement Program's (JFMIP) *Framework for Federal Financial Management Systems*, Chapter 3, states that processing covers those mechanisms necessary to properly process and track data on financial events."

Recommendation

We recommend that the FAA develop a communication and coordination plan to ensure timely, complete, accurate information regarding legal matters is routinely provided to and reviewed by the AFM. The information must be sufficiently complete to allow the AFM to properly state legal liabilities in the financial statements and the notes thereto, in compliance with applicable accounting standards.

Reportable Conditions

We consider the following to be reportable conditions.

2. Controls and processes over financial reporting and account reconciliations

Condition

The financial statements initially produced by FAA's financial reporting processes and systems required substantial review and adjustment in the post-closing process to produce materially correct financial statements. The current financial reporting process places significant reliance on the AFM's manual reviews and reconciliations that increase the likelihood that error or oversight could occur. Also, a number of account analyses and reconciliation procedures were not performed routinely during fiscal year 2002, resulting in a significant number of material post-closing adjustments. Controls over the financial reporting process should be improved to ensure related budgetary and proprietary accounts are in agreement, abnormal account balances are minimized, promptly identified and investigated, intra entity transactions are correctly eliminated, unearned revenue is properly recorded as deferred revenue, and reimbursable activity is correctly recorded.

We noted the following matters that affected the FAA's ability to produce accurate financial statements:

- Fiscal year 2001 audit adjustments were incorrectly allocated to the lines of business on the statement of net cost based on the financial activity that occurred in the month of September instead of activity for the entire year. The FAA revised the fiscal year 2001 statement of net cost to reflect the proper allocation of audit adjustments to the entire year. The revision did not have an effect on fiscal year 2001 total net costs.

- Fiscal year 2002 earned revenue of $116 million was not properly classified on the statement of net cost, resulting in revenue that significantly exceeded expenses in the *Costs Not Assigned to Programs*.

- Fiscal year 2002 intra-entity expenses of $260 million related to Franchise Fund operations were incorrectly eliminated against the FAA's lines of business.

- Related budgetary and proprietary general ledger accounts did not agree. Specifically, collections of advance payments totaling $35 million were recorded in proprietary, but not corresponding budgetary general ledger accounts. Reimbursable expenses totaling $45 million were incorrectly recorded as appropriations used. Also, revenue totaling $46 million for reimbursable activities was recorded against the incorrect budgetary general ledger account.

- The FAA has not assessed the financial reporting impact, if any, of its FMFIA reported control weakness related to its process for closing-out cost reimbursable contracts. In its report dated May 8, 2002, the OIG reported control weaknesses in this process and identified approximately $130 million of potential unallowable costs that could be identified by incurred costs audits.

- The Franchise Fund did not correctly record $6.6 million of unearned revenue as deferred. As a result, fiscal year 2002 revenue was overstated.

- The Franchise Fund did not properly record the receipt of inventory delivered without an invoice. As a result, both accounts payable and expenses were misstated by approximately $3 million.

Upon investigation the AFM made appropriate adjustments to the fiscal year 2002 financial statements to correct the discrepancies noted above. In addition during the post-closing review process and in response to our audit inquires, the AFM detected and corrected the following additional discrepancies:

- Although the statement of budgetary resources is presented on a combined basis and therefore intra-entity transactions are not eliminated, certain intra-entity transactions distorted budgetary resources and obligations by $5.8 billion and required an adjustment to offset the balances for financial statement presentation purposes.

- Note 2, Status of fund balance with Treasury related to fiscal year 2001, misstated the *Available Unobligated Balance* and *Obligated Balance Not Yet Disbursed* by $3.2 billion.

- The beginning unobligated balance in the budgetary resources section of the statement of budgetary resources required a retroactive adjustments to increase the balance by $302 million to properly account for fiscal year 2001 grant contract authority previously reported as temporarily unavailable and decrease the balance by $113 million to correctly report unfilled customer orders.

Criteria

OMB Circular A-123 states that financial managers must incorporate certain specific management controls standards and ensure that transactions are promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports.

Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting,* states that Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that:

- Transactions are executed in accordance with budgetary and financial laws and other requirements are consistent with the purpose authorized, and are recorded in accordance with federal accounting standards;

- Assets are properly safeguarded to deter fraud waste, and abuse; and

- Performance measurement information is adequately supported.

The three objectives should be accomplished in conjunction with the fact that accounting supports both effective management and control of organizations and the process of reporting useful information. Accounting processes are an integral part of the management control system. The ability to prepare financial reports that report all transactions, classified in appropriate ways that reliably represent the underlying events, is itself an indication that certain essential controls are in place and operating effectively. The preparation of reliable financial reports also helps to ensure that reporting entities have early warning systems to indicate potential problems and take actions to correct material weaknesses or problems.

Recommendation

Since the FAA will be converting to DOT's new accounting system in the near future, we recommend that the AFM establish compensating controls to detect and correct the discrepancies identified and other matters of this nature. In conjunction with this effort, we recommend that the FAA routinely reconcile and resolve budgetary and proprietary account differences, and perform account and subledger analyses and reconciliations on other key accounts throughout the year, in order to produce reliable interim financial reports and reduce the number of post-closing adjustments at year-end. We also recommend that FAA assess the financial reporting impact related to weaknesses in its process for closing-out cost reimbursable contracts.

3. Process for estimating environmental liabilities

Condition

The FAA's estimate for environmental liabilities is comprised of two components – the costs to remediate known contaminated sites and the costs to cleanup and decommission active facilities at a future date. Within the FAA, there are two different offices involved with developing and documenting the costs associated with these two components. The Environmental, Energy, and Safety Division (AFZ-800) is the primary office responsible for environmental remediation and the Investment Analysis and Operations Research Division (ASD-400) is the primary office responsible for environmental cleanup and decommissioning. Together they compile a summary listing of estimated environmental cleanup liabilities, which is needed to produce timely, reliable financial statements.

Although improvements were made during the current year, both offices lack adequate policies and procedures to consistently and accurately determine the estimated environmental liability for financial statement purposes. Specifically, within the Environmental, Energy and Employee Safety Division, we noted a lack of:

- Periodic reporting of adjustments to the AFM during the year to refine estimates and to facilitate accurate interim reporting;
- Completeness of listed liabilities (for both known and unknown clean-up);
- Comprehensiveness of instructions provided to regional personnel; and
- Documentation of planning assumptions that will ensure consistency in application of estimating methods and applicable accounting standards.

Within the Investment Analysis and Operations Research Division, we noted a lack of:

- Documentation of planning assumptions on contaminate type and quantity; and
- Cost estimating models for each type of facility that includes appropriate financial statement criteria (e.g. conditions necessary to estimate and accrue a liability).

Criteria

SFFAS No. 5 defines a liability as a probable future outflow or other sacrifice of resources as a result of past transactions or events. SFFAS No. 6, *Accounting for Property, Plant, and Equipment,* defines cleanup costs as the costs of removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated property, plant and equipment. Cleanup may include, but is not limited to, decontamination, decommissioning, site restoration, site monitoring, closure, and post closure costs. Federal Financial Accounting and Auditing Technical Release No. 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*, states that an agency is responsible for recognizing a liability for environmental cleanup costs resulting from past transactions or events when a future outflow or other sacrifice of resources is probable and can be reasonably estimated.

Recommendations

To improve the reliability, relevance and timeliness of information received by the AFM regarding environmental remediation, we recommend that the AFM, in conjunction with the Environmental, Energy, and Safety Division:

- Establish a process to provide periodic reporting for environmental liabilities;

- Develop and report estimates in current year dollars;

- Consider a risk-based evaluation of uninspected facilities to determine if any environmental remediation exists. This evaluation should focus on those facilities that are similar in function and design as other facilities in which the FAA has determined contamination exists;

- Develop guidance for Environmental Site and Cleanup Report (ESCR) preparation and documentation requirements; and

- Improve documentation and quantification of planning assumptions.

Regarding the environmental cleanup and decommissioning estimate, we recommend that the AFM, in conjunction with Airways Facilities and the Investment Analysis and Operations Research Division:

- Establish a process to provide quarterly reporting for environmental liabilities;

- Improve the planning assumption documentation to include information on the contaminate type and quantity;

- Develop cost estimating models for each facility type; and

- Establish a cost/schedule baseline estimate for the environmental cleanup and decommissioning scope of work.

4. Accounting Methods and Controls over Field Spares

Condition

The FAA did not have adequate controls to ensure all recorded field spares existed and that all items on hand were recorded.

Prior to fiscal year 2002, the FAA recorded field spares as operating materials and supplies using the consumption method as outlined in SFFAS No. 3, *Accounting for Inventory and Related Materials*. Under the consumption method, field spares were maintained at full value until the FAA disposed of the item. At that time the full cost of the item was treated as an expense. During fiscal year 2002, the FAA reevaluated its accounting treatment for field spares and determined that treating the spares as a component of property, plant and equipment (PP&E) in accordance with SFFAS No. 6 better represented actual operations as the cost of the field spares would be recorded as an expense, through depreciation, over the period of time that the field spares support the respective equipment. Accordingly, for financial statement presentation in fiscal year 2002, the FAA reclassified field spares from operating materials to PP&E, and recognized the retroactive accumulated depreciation that would have occurred prior to fiscal year 2002. This change in accounting method will require that the FAA design and implement a new method of accounting for field spares that are sent to the Franchise Fund for repair and/or replacement. Presently, the Franchise Fund records incoming field spares at weighted average cost – the same as new inventory held for sale. The new accounting method will result in recognition of periodic depreciation expense on those assets and any adjustment to carrying value, other than through depreciation, may result in a financial statement misstatement.

The FAA uses the Field Spares Inventory (FSI) module of the Logistics Inventory System as a subsidiary ledger to support field spare balances presented in the financial statements. The FSI module does not have an adequate transaction history and is not a perpetual inventory system. To ensure completeness of field spare quantities in FSI, the FAA must rely on periodic physical inventories and other controls. Our tests of control indicated that the periodic inventories and other controls may not be properly designed to ensure recorded quantities exist, and that actual quantities on hand are recorded. Further, tests of balances showed that errors occurred, and were not detected, as some locations did not properly report field spares in the correct inventory location. In addition, at some locations, the recorded quantities were incorrect due to confusion when both components and subcomponents were involved. We also noted a lack of supporting documentation related to new issuances and the commissioning of new equipment. Accurate tracking of field spare quantities will be especially important since depreciation expense will now be recognized on the balance. It will also be important to properly match the field spare as a component of the asset it supports to ensure proper matching of depreciation with useful life and to properly record disposals as they occur.

Criteria

SFFAS No. 6 defines general property, plant, and equipment as any property, plant, and equipment used by an entity in providing goods or services. The standard further states that depreciation expense for PP&E is calculated through the systematic and rational allocation of the cost, less its estimated salvage/residual value, over the estimated useful life of the general PP&E. Any adjustment in carrying value other than through depreciation, or other impairment, will be inconsistent with FAA's newly adopted accounting policy. Therefore field spares received by the

Franchise Fund in exchange for new or refurbished spares, can not be inventoried at weighted average cost, for financial statement purposes, as was done in the past

OMB Circular A-123, states that proper stewardship of Federal resources is a fundamental responsibility of agency managers and staff. Federal employees must ensure that government resources are used efficiently and effectively to achieve intended program results. Resources must be used consistent with agency mission, in compliance with laws and regulations, and with minimal potential for waste, fraud, and mismanagement. The Circular further states that transactions should be promptly recorded, and properly classified and accounted for, in order to prepare timely accounts and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

Recommendations

We recommend that the AFM:

- Implement procedures to ensure that field spare quantities are adequately recorded and tracked as a component of PP&E.

- Evaluate the accounting methodology used by the Franchise Fund to account for returned field spares to ensure that the financial statements properly reflect depreciation and do not include adjustments for changes in value (other that depreciation expense) once the field spare is issued by the Franchise Fund.

5. Controls over Property, Plant and Equipment

Condition

The FAA did not fully adhere to its policies and procedures designed to ensure that PP&E is stated in accordance with accounting principles generally accepted in United States of America. We noted deficiencies in the following areas:

- *Reconciliations* – The FAA did not reconcile its PP&E sub-ledger (IFAS) to the general ledger throughout the year. Since IFAS is not integrated with the FAA's general ledger, property transactions must be entered separately from those entered into the general ledger accounting system. Transactions related to real property are entered directly into IFAS, but personal property (i.e., equipment) transactions are first entered into a legacy property management system, which is then transferred to IFAS. The lack of electronic interface between IFAS and the general ledger greatly increases the likelihood that the two systems will, from time-to-time, not agree due to a backlog of input to either system or errors that occur in entering the data. The initial transaction (disbursement or receipt related to a property transaction) is recorded in the general ledger system, however depreciation is computed from data in IFAS. If IFAS is not updated timely, the financial statements will not accurately reflect depreciation expense.

  In addition, we noted that the FAA had difficulty preparing a year-end roll-forward of fixed asset additions and disposals by category and thus unable to clearly support composition of changes in PP&E.

- *Additions and disposals* – Regional personnel did not record property disposals in a timely manner. This situation negatively affected the AFM's ability to produce accurate interim financial statements and management reports. It also resulted in a substantial effort to research months-old data to prepare an accurate closed trial balance at year-end. If uncorrected, this situation will likely put in jeopardy the FAA's ability to adhere to new OMB reporting requirements for interim reporting during fiscal years 2003 and beyond.

- *Construction-in-process (CIP) transfers* – The FAA has not recorded the transfer of completed construction projects in a timely manner after the asset has been placed –in service. We noted that the primary reason for the delay is that: (i) responsible personnel in the regional offices often focused on clearing older completed CIP projects as there was little incentive to transfer costs for newly completed projects (within 180 days of date that an asset is commissioned), or (ii) costs could not be transferred until the requirement to have 97 percent of the supporting documentation was met. This situation could result in an understatement of depreciation expense, since assets classified as CIP will not begin to depreciate in IFAS until an in-service date has been established. This situation has been a longstanding, recurring problem for the FAA that impacts financial management. Also, projected commissioning dates were not updated when changes occurred.

- *Capitalization of labor and travel costs* – Technical Support Service Contractor (TSSC) labor and travel costs related to PP&E was not properly processed as some costs were incorrectly capitalized as stand alone assets.

Criteria

JFMIP's *Core Financial System Requirements*, states that the core financial system must maintain detailed information by account sufficient to provide audit trails and support managerial cost accounting. It further states that costs should be captured at the lowest level to reflect actual costs incurred by the agency in providing goods and services. The detail transactions should be timely recorded in subsidiary ledgers and interfaced or timely reconciled with the general ledger. Cost tracking should be sufficiently detailed to explain the change in account balances during any period of time need.

OMB Circular A-123 states that transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

SFFAS No. 6 requires that constructed PP&E be recorded as construction work in progress until the asset is placed in service, at which time it is to be transferred to general PP&E, and depreciation expense should be taken over the estimated useful life of the asset.

SFFAS No. 6 also states that all general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include: amounts paid to vendors; transportation charges to the point of initial use; handling and storage costs; labor and other direct or indirect production costs (for assets produced or constructed); engineering, architectural, and other outside services for designs, plans, specifications, and surveys; etc.

Recommendations

We recommend that the AFM:

- Develop and implement formal periodic financial reporting processes to reconcile the PP&E recorded in IFAS to the general ledger and record additions and disposals in a timely manner;

- Ensure that there is appropriate staffing to complete and review these periodic month-end reporting procedures, and that regional offices fully cooperate in providing information to the AFM in a timely manner;

- Prepare a roll-forward of fixed assets on a regular basis, at least quarterly, as a high level review of the activity in PP&E and help ensure that all transactions have been properly coded and recorded;

- Improve its policy regarding accounting for construction-in-progress and to ensure a timely matching of depreciation expense with assets placed in-service; and.

In conjunction with the Assistant Administrator for Regions and Center, reemphasize the need to follow procedures related to recording property disposals timely and ensuring TSSC labor, travel and other costs necessary to put an asset in place are correctly capitalized.

6. Information Technology Controls over Third-party Systems and Applications

Condition

Certain general controls related to the FAA's primary financial applications owned by Department of Transportation (DOT) need to be strengthened. Specifically, security program planning and management related to the development, certification, and accreditation of security programs for these applications were not effectively coordinated with the FAA Information Systems Security Officers, who have a shared responsibility to ensure that risk factors were appropriately known and considered. Also, application software development practices did not provide for effective and sustainable maintenance of these financial applications. Additionally, access controls for sensitive and critical functions were not based on least privilege principles.

As part of our audit, we performed a limited scope general controls review of information technology controls over the following key systems that support FAA's financial transactions and reporting:

- Departmental Accounting and Financial Information System (DAFIS)
- Integrated Personnel and Payroll System (IPPS)
- Consolidated Uniform Payroll System (CUPS)
- Consolidated Personnel Management Information System (CPMIS)

The development, certification, and accreditation of security programs for these four applications needed improvement. Also, there were weaknesses in the areas of access control and application software development and change control for all four applications. Due to the sensitive nature of these issues, we provided the detailed results of our review, along with specific recommendations, separately to management.

To operate these key financial systems, the FAA contracted with NITC, located in Kansas City, Missouri, to provide information technology resources for the operation of key FAA financial systems. Accordingly, NITC is responsible for establishing and maintaining effective internal controls. In coordination with the DOT's Office of Inspector General, the USDA's OIG conducted a review of NITC in accordance with Statement of Auditing Standards No. 70, *Service Organizations*. The USDA OIG identified weakness in the areas of security program planning and management, access controls, and system software concerning FAA operations at NITC. The report identified controls that were (1) properly designed and operating effectively, (2) properly designed, but not operating effectively, and (3) not properly designed. However, the report was not issued to DOT OIG until January 13, 2003, limiting its usefulness for planning and executing the FAA's fiscal year 2002 consolidated financial statement audit.

In addition, the FAA has an agreement with the Federal Transit Administration (FTA) to use the Electronic Clearinghouse Operation (ECHO) system to process payment requests and disbursements for the majority of the FAA's grants under the Airport Improvement Program. Accordingly, FTA is responsible for establishing and maintaining an effective internal control structure. FTA did not have an independent assessment of its control structure as discussed in SAS 70 or any other type of independent review of its control structure. Without a SAS 70 or other type of independent review, there is an increased risk that control weaknesses may exist at FTA that may not be known to the FAA.

Criteria

Appendix III, OMB Circular No.A-130, *Management of Federal Information Resources*, requires Federal agencies to establish application security plans to assure that adequate security is provided for information collected, processed, transmitted, stored, or disseminated through the system.

National Institute of Standards and Technology (NIST) Special Publication No. 800-18, *Guide for Developing Security Plans for Information Technology Systems*, states the purpose of security plans are to provide an overview of the security requirements of the system and describe the controls in place or planned for meeting those requirements; and delineate responsibilities and expected behavior of all individuals who access the system.

SAS 70 states: "When a user organization uses a service organization, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. The significance of the controls of the service organization to those of the user organization depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the user organization and the degree of interaction between its activities and those of the user organization."

Recommendations

We recommend that the AFM improve information technology controls over third-party systems and applications by:

- Monitoring the progress of the FAA organizations responsible for implementing the specific recommendations previously provided – not repeated here due to the sensitive nature of the recommendations content;

- In conjunction with the DOT OIG, request that the USDA OIG complete its review of the FAA operations at NITC sooner; and

- In conjunction with DOT, request FTA to have an independent review performed, preferably in accordance with SAS 70, and prepare a report on controls placed in operation and tests of operating effectiveness related to the ECHO system.

7. Information technology controls over FAA systems

Condition

Certain general controls associated with a key FAA-owned financial system, the Logistics Inventory System (LIS), needed improvement. Specifically, improvements were needed in overall security program planning and management, access controls and applications software development and change control.

As part of our audit, we performed a limited scope general controls review of information technology controls over LIS, which is a key FAA financial and logistical system. The FAA had designated LIS as a mission critical system as it provides control and distribution of logistical material for the National Airspace System. The FAA has not developed an information systems security program for LIS. Also, there were weaknesses in the areas of access controls and application software development and change control. Due to the sensitive nature of these issues, we provided the detailed results of our review along with specific recommendations separately.

Criteria

Appendix III, OMB Circular No. A-130, requires Federal agencies to establish application security plans to assure that adequate security is provided for information collected, processed, transmitted, stored, or disseminated through the system.

NIST Special Publication No. 800-18, states the purpose of security plans are to provide an overview of the security requirements of the system and describe the controls in place or planned for meeting those requirements; and delineate responsibilities and expected behavior of all individuals who access the system.

Recommendation

We recommend that the AFM monitor the progress of those within FAA who are responsible for implementation of the specific recommendations associated with LIS.

Status of Prior Year Reportable Conditions, and Compliance with Laws and Regulations

Prior Year Conditions	As Report at September 30, 2001	Status as of September 30, 2002
Property, Plant, and Equipment	**Material Weakness:** FAA was unsuccessful in implementing an integrated property accounting system, calculated depreciation expense and the net book value of its property, plant, and equipment using electronic spreadsheets outside the existing property system, and these amounts could not be substantiated.	**Reportable condition:** FAA implemented five of the six recommendations and substantially improved controls over PP&E. Thus, this reportable condition is no longer deemed a material weakness. However, additional improvements are needed.
Inactive Obligations	**Reportable Condition:** FAA did not perform sufficient reviews to identify inactive obligations.	**No longer deemed a reportable condition:** FAA implemented procedures to resolve this issue.
Personal Property Acquisitions	**Reportable Condition:** FAA yearend review procedures of personal property transactions did not include regional offices.	**No longer deemed a reportable condition:** FAA revised its yearend procedures to include review of regional property transactions.
Non-Compliance with FFMIA	**Non-Compliance with Laws and Regulations:** FAA was not in substantial compliance with FFMIA because: (1) DOT's core accounting system, DAFIS, cannot produce auditable financial statements and is not compliant with the U.S. Standard General Ledger at the transaction level; (2) security over financial information systems needed to be improved; (3) managerial cost accounting standards were not fully implemented; and (5) the financial management systems are not fully integrated.	**Continue as an instance of non-compliance with laws and regulations:** The FAA continues to remain substantially non-compliant with FFMIA. FAA continues to make progress in implementing managerial cost accounting, however, full implementation has not yet been achieved.

Compliance with Laws and Regulations

This section discusses an issue related to the Federal Financial Management Improvement Act of 1996 (FFMIA).

Condition

The FAA was not in substantial compliance with FFMIA.

Discussion

The FAA uses the DOT's core accounting system DAFIS to process and record financial transactions. DAFIS does not comply with the United States Standard General ledger (USSGL) or Federal financial management system requirements, which call for a single, integrated financial system. The FAA is planning to convert to DOT's new core accounting system during fiscal year 2003. DOT considers the new system to meet Federal systems requirements and process transactions at the USSGL level. As reported last year, the FAA has not fully implemented managerial cost accounting, however, additional progress was made during fiscal year 2002.

Criteria

FFMIA requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the USSGL at the transaction level.

Recommendation

We recommend that the FAA work aggressively to implement the new DOT accounting system.